STATE OF WISCONSIN : CIRCUIT COURT : DANE COUNTY

In the Matter of the Rehabilitation of:

SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION	**Case No. 10 CV 1576** **Hon. Richard G. Niess**

REHABILITATOR'S BRIEF IN SUPPORT OF ITS MOTION TO FURTHER AMEND THE PLAN OF REHABILITATION CONFIRMED ON JANUARY 24, 2011 TO FACILITATE AN EXIT FROM REHABILITATION

Dated: September 25, 2017.

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I. INTRODUCTION

The purpose of this motion is to obtain the Rehabilitation Court's approval of further amendments to a plan of rehabilitation to allow a settlement between a segregated account in rehabilitation and its primary creditors and to obtain an order, pursuant to section 645.35 (2), facilitating an exit from the rehabilitation and terminating the proceedings. The standard that applies provides as follows:

> (2) ORDER TO RETURN TO COMPANY. The rehabilitator may at any time petition the court for an order terminating rehabilitation of an insurer. If the court finds that *rehabilitation has been accomplished* and that grounds for rehabilitation under s. 645.31 *no longer exist*, it *shall* order that the insurer be restored to possession of its property and the control of its business. The court may also make that finding and issue that order at any time upon its own motion.

See Wis. Stat. § 645.35(2) (emphasis added). The issue presented is whether the purpose of the rehabilitation has been accomplished, meaning, whether the settlement satisfies, or accounts for, the outstanding obligations of the segregated account and leaves the insurer financially stable such that "[the] grounds for rehabilitation under s. 645.31 no longer exist." *See* Wis. Stat. § 645.35(2). As demonstrated below, the statutory standard has been met and this motion should be granted.

Ambac Assurance Corporation ("**AAC**"),[1] Ambac Financial Group ("**AFG**") and a group of creditors (the "**Ad Hoc Group**")[2] holding a material percentage of Deferred Payment

[1] Capitalized terms used but not otherwise herein defined have the meanings ascribed to them in the proposed Second Amended Plan and the Payment Guidelines, each as the case may be.

[2] The original group included four creditors: CarVal Investors, LLC, Canyon Partners, LLC, Davidson Kempner Capital Management, LLC, and Centerbridge Partners; the group now includes a fifth fund, EJF Capital LLC, and as a result of trading has expanded further. *See* Affidavit of Brian D. Pfeiffer dated September 21, 2017 ("**Pfeiffer Aff.**") at ¶¶ 2, 4, p. 2.

Obligations ("**DPOs**")[3] and a majority of General Account Senior Surplus Notes (the **"GA Surplus Notes"** or **"GA SSNs"**),[4] have reached a consensual resolution for the final treatment of claims. Their agreement will allow substantial payments to all creditors and facilitate an exit of the Segregated Account from rehabilitation. AAC has obtained signed commitments from 61% of DPO holders and at least 60% of GA Surplus Note holders (including amounts held by AFG and in AAC's General Account) to carry out the terms of a consensual resolution (the "**Consensual Transaction**" or "**Transaction**"); provided however, the Transaction must close by April 15, 2018.[5]

The Consensual Transaction satisfies previously adjudicated claims (also known as crystalized claims) in full and results in non-affiliated Deferred Amount beneficiaries and tendering GA Surplus Note holders effectively receiving a combination of cash and senior securities of 81 cents per dollar of claims plus 12.5 cents in aggregate par amount of existing marketable (*i.e.* tradeable) surplus notes. The agreed upon consideration in the Transaction thus totals 93.5 cents in cash, Senior Secured Notes, and GA Surplus Notes per dollar of Deferred Amounts and tendered GA Surplus Notes, with the balance of 6.5 cents per dollar being a discount taken against accrued accretion (in the case of DPOs) or interest (in the case of Surplus Notes); one hundred percent (100%) of the principal amount of all underlying claims are to be paid in full. The Transaction also includes an immediate interest payment of approximately

[3] DPOs are also referred to as "Deferred Amounts" pursuant to the Definitions in the Plan; as an important point of clarification however references in this Motion to Deferred Amounts are to only Pre-Record Date Deferred Amounts, holders of which will receive the consideration set forth in the Plan per the terms of the Transaction.

[4] Claims commutations in this case have involved the issuance of Surplus Notes by the Segregated Account and the General Account. AFG however has acquired all the Segregated Account Surplus Notes. This Motion and the Consensual Transaction therefore address consideration to be exchanged with General Account Surplus Note Holders; references to "GA Surplus Notes" or "Surplus Notes" hereinafter are to only the General Account Senior Surplus Notes.

[5] The term "Consensual Transaction" is used to differentiate from a non-consensual exit that would involve the Rehabilitator, upon Court approval, imposing the terms of an exit on all parties. The use of "consensual" to describe the Transaction is not meant to imply that all holders of Deferred Amounts or GA Surplus Notes have consented.

2.5% on the remaining Surplus Notes, equating to about $13 million, thus further increasing the cash consideration. For all future claims tendered to AAC post-exit (*i.e.* current non-crystalized claims), policyholders are expected to receive full payment, in cash, and be paid in the normal course of business.

A condition precedent to the Consensual Transaction is the approval by this Court of the amendments that are contained in the Second Amended Plan of Rehabilitation (the "**Second Amended Plan**") of the Segregated Account of AAC (the "**Segregated Account**") that is now being proposed by the Office of the Commissioner of Insurance, as rehabilitator of the Segregated Account (the "**Rehabilitator**"). In the Rehabilitator's judgment, this outcome — consideration of 93.5 cents per dollar in cash, Senior Secured Notes, and GA Surplus Notes exchanged today on outstanding obligations and payment in full on prospective claims — is superior to maintaining the status quo for perhaps as long as 37 years. In other words, the present value of consideration received under the Consensual Transaction is estimated to be greater than the present value of the recovery that would occur under the existing Plan. In fact, prolonging the Rehabilitation under the existing Plan would lead to a lengthy, expensive run-off, continue the disparate treatment of policyholders,[6] significantly delay the payment of crystalized claims, and prevent the full payment of non-crystalized Segregated Account claims for the foreseeable future.

With the assistance of its professional advisors, the Rehabilitator has independently determined that AAC will be immediately stable post-exit upon closing the Transaction, which

[6] Since 2014, when this Court confirmed the First Amended Plan of Rehabilitation, Segregated Account policyholders have received payment for less than half, or 45 cents for every dollar value of claims presented (excepting however this Court's August 2, 2013 order allowing for supplemental payments). DPO holders have thus effectively received an I.O.U. for 55 cents on the dollar and their claims are to be paid, not when presented, but rather at a later, uncertain date. General Account policyholders on the other hand have received full payment, or 100 cents on every dollar, of valid claims presented to AAC.

means the terms of the Consensual Transaction will foster a durable exit from Rehabilitation. The Rehabilitator has thus concluded that the Consensual Transaction and Second Amended Plan best serve the goals of Rehabilitation as established by Wisconsin statutes and precedent. As such, the Second Amended Plan meets the statutory requirements for terminating these proceedings.

The proposed Second Amended Plan and Disclosure Statement are being filed concurrently with this Motion. AAC, AFG, and the Ad Hoc Group have consented in writing to the Second Amended Plan and join in the Rehabilitator's Motion to pave the way for the Consensual Transaction.[7] This Motion is further supported by the Affidavit of Daniel J. Schwartzer, Special Deputy Commissioner, which includes the Expert Report of Dennis M. McGettigan, the Rehabilitator's primary financial advisor. Also accompanying this Motion is a Motion for a Scheduling Order that seeks to establish a schedule for the Court to hear objections, if any.[8] Once the Transaction, if approved, closes, the Rehabilitation Proceeding will be terminated and the Special Deputy Commissioner ("**SDC**") may be discharged pursuant to a subsequent Final Decree and Discharge Order.

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[7] These parties executed a Rehabilitation Exit Support Agreement ("**RESA**") in which they committed to support the Rehabilitator's Motion, and then close the transaction, conditioned upon this Court's approval of the Second Amended Plan. The RESA was subsequently amended to further accommodate the Second Amended Plan and amended Payment Guidelines necessary to timely close the Transaction. The AHG also separately provided an affidavit of counsel attesting to the group's support of the Transaction generally and intent to carry out the Consensual Transaction in accordance with the terms of the RESA. *See* Pfeiffer Aff., ¶ 8.

[8] As an integral part of the proposed Second Amended Plan, the Rehabilitator has also amended the corresponding Payment Guidelines and LVM Payment Guidelines to effectuate the changes outlined herein. To the extent that circumstances arise requiring a modification or amendment of the Motion, the proposed Second Amended Plan, or the Scheduling Order, the Rehabilitator reserves the right to supplement and/or amend such items and schedule as appropriate to better facilitate the exit from Rehabilitation. *Unless and until confirmation of the Second Amended Plan by the Court, the existing Amended Plan and all other orders of the Court remain in full force and effect; the Payment Guidelines are being amended as discussed below but only to the extent necessary to conditionally carry out the Consensual Transaction pending approval by this Court.*

II. SUMMARY OF THE FIRST AMENDED AND PROPOSED SECOND AMENDED PLANS OF REHABILITATION

A. The First Amended Plan

On June 12, 2014, this Court approved the Rehabilitator's motion to amend the Plan of Rehabilitation originally dated January 24, 2011 (together with the 2014 amendment, the "**Plan**"). Those Plan amendments served as the mechanism that allowed the Segregated Account to pay a portion of its policy obligations, avoid negative tax consequences to AAC and certain Holders, and begin the process of de-risking the Segregated Account. Since that time, there have been numerous significant developments.

To begin, AAC and the Rehabilitator have successfully commuted many original policyholder claims and adverse swap exposures thereby reducing the overall risk of the Segregated Account's insured portfolio. AAC's investment portfolio has also been better aligned with its liabilities. Next, AAC's parent company, AFG, acquired all outstanding Segregated Account Surplus Notes and additional GA Surplus Notes, and agreed to less favorable treatment under the Transaction, which provided AAC with greater flexibility in reaching an agreement with the Ad Hoc Group. AAC negotiated the Consensual Transaction, which included a capital raise and issuance of new Senior Secured Notes (which could not be issued without the consent of AAC and AFG), to be incorporated as part of a Second Amendment Plan, that provides a structure to pay the principal of all Deferred Amounts with only immaterial exceptions noted below, and exit the Segregated Account from Rehabilitation.

B. The Second Amended Plan, as Proposed

The Second Amended Plan incorporates the material terms of the Consensual Transaction. As the Transaction was being negotiated, the Rehabilitator monitored the parties' negotiations and evaluated the merits of multiple proposed transactions. The SDC and the

Rehabilitator then independently analyzed the terms of the agreed upon Consensual Transaction, each concluding that it meets OCI's structural durability test. In doing so, the Rehabilitator has taken a conservative approach and has set capital requirements taking into account what the Rehabilitator believes to be reasonable stress case scenarios. The durability test also incorporates a margin of safety requirement to ensure that future claims will be paid and AAC will remain a viable entity going forward; the margin of safety represents an economic buffer to guard against unforeseen future events and potential estimation errors.[9]

The Second Amended Plan, together with certain transactions to occur alongside, generally allows for the following series of exchanges:

- An effective consideration package for Holders of DPOs and tendered Surplus Notes through a combination of new Senior Secured Notes, existing GA Surplus Notes, and cash consideration (financed from multiple sources, including a new debt issuance tied to RMBS Litigations (defined below) proceeds (the "**Tier 2**" financing));
- A discount of 6.5% in payment afforded to the Holders of tendered Surplus Notes and all DPOs, to be applied against accretion amounts; 100% of the principal amount of all underlying claims are to be paid in full;
- The merger of any remaining Segregated Account liabilities back into AAC's General Account (the "**Merger**");
- Conclusion of these Proceedings by a Final Decree and Discharge Order after the closing of the Consensual Transaction; and,
- Payment of all future Claims in full, in cash, on a going-forward basis.

The centerpiece of the Consensual Transaction is the issuance of up to approximately $2.1 billion in aggregate par value of new Senior Secured Notes, with up to approximately $1.5 billion issued to third parties including AFG (the "**Senior Secured Notes**") that, along with cash

[9] Affidavit of Daniel J. Schwartzer dated August 31, 2017 ("**Schwartzer Aff.**") at ¶ 15, which incorporates the Expert Report of Dennis M. McGettigan as Exhibit C ("**McGettigan Expert Report**").

and GA Surplus Notes that remain outstanding after the Effective Date, forms the consideration package for the DPOs and GA Surplus Notes.[10]

The new Senior Secured Notes will be secured by a pledge of AAC's right to up to $1.4 billion of proceeds from residential mortgage backed securities ("**RMBS**") litigation in which AAC and the Segregated Account are plaintiffs, including the anticipated judgment or settlement proceeds in the case of *Ambac Assurance Corp. v. Countrywide Securities Corp. and Bank of America Home Loans*, currently pending before the New York State Supreme Court, the details of which are described below. In addition, the Senior Secured Notes will also be secured by certain AAC-owned RMBS investment assets with a market value of at least $350 million, as well as the proceeds of AAC's Senior Secured Notes. AAC will also issue a full-recourse financial guaranty policy on the Senior Secured Notes. AAC has also received written commitments from third-party investors to purchase $240 million of Tier 2 financing debt.[11] As a result, the Rehabilitator believes the Consensual Transaction is in the best interests of policyholders and provides a basis for a durable exit from Rehabilitation.

III. THE PROPOSED TREATMENT OF CLAIMS UNDER THE SECOND AMENDED PLAN, SUMMARIZED BY CLASS

A. Payment Obligation Classifications in the First Amended Plan

The Consensual Transaction sets forth the mechanism to satisfy payment liabilities of the

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[10] The 6.5% discount will be taken against accretion. An estimated $3.8 million of the discount will nominally affect principal amounts. However, as of June 30, 2017, all but approximately $25,000 of the $3.8 million is attributed to a minority of underlying transactions in which the insured securities received interest from the trust on certificate balances. The receipt of interest more than offsets any principal reduction in most deals, leaving a miniscule net impact on principal of $25,000 (or .0007% on $3.8 billion). AAC and the AHG have therefore agreed in amendments to the RESA that the $25,000 in claims may be paid directly by the Company or the discount reduced, such that the end result is that the principal of all policy claims will be paid in full. *See* First Amendment to the Rehabilitation Exit Support Agreement, ¶ 2.3, p. 2 (Sept. 22, 2017).

[11] The Tier 2 financing is fully committed new capital that is secured by potential recoveries in the RMBS Litigations in excess of $1.6 billion (net of reinsurance), carry an 8.5% interest rate and mature in 2055, with substantial prepayment conditions, as further described in the Disclosure Statement.

Segregated Account and, for purposes of addressing the Rehabilitator's durability concerns, also addresses AAC's liabilities. These payment liabilities include: (a) DPOs, (b) Segregated Account Surplus Notes, (c) Junior Surplus Notes, and (d) General Account Surplus Notes.[12] The Second Amended Plan changes the existing payment structure of DPOs and Segregated Account Surplus Notes, thus requiring amendments to the Plan. For ease of comparison, a summary of the existing Plan's treatment of Claims includes the following:

Plan Class	Claim Type	Deferred Type
Class 1	Administrative Claims	None
Class 2	Permitted Policy Claims (Interim Payments)	None (45% payment upon claim presentation)
	Permitted Policy Claims (Deferred Amounts)	Segregated Account– Principal Amount
		Segregated Account– Accretion Amount
Class 3	Permitted General Claims	Junior Deferred Amounts – Principal
	Permitted General Claims	Junior Deferred Amounts – Accretion Amount
Class 4	Permitted Policy Claims (Reconciliation Amounts)	Treated as Class 2 Claims
Class 5	Segregated Account Surplus Notes	Segregated Account – Principal
		Segregated Account – Interest
	Junior Surplus Notes	Segregated Account – Principal
		Segregated Account – Interest

B. The Exchanges Under the Second Amended Plan Will Alter the Treatment of Classes of Segregated Account Claims

As part of the Second Amended Plan, the Rehabilitator proposes to alter the treatment of various Classes of Claims. This Motion provides only a summary of the proposed treatment, and as such, the statements herein are fully qualified by the terms and provisions in the proposed Second Amended Plan; **to the extent this summary in any way conflicts with the terms and provisions of the Second Amended Plan, the Second Amended Plan controls**. Interested Parties are urged to review the Second Amended Plan and Disclosure Statement in their entirety.

[12] General Account Surplus notes are not subject to rehabilitation and not itemized in the table below.

(1) Class 1 – Administrative Claims. There is no proposed change to the treatment of Class 1 Claims in the Second Amended Plan. Permitted Administrative Claims shall be satisfied or paid in the normal course.

(2) Class 2 – Policy Claims (Deferred Amounts).[13] The Second Amended Plan provides for an initial exchange, to be completed in conjunction with and immediately prior to the allocation of Plan distributions to facilitate the distribution of Cash and the Senior Secured Notes to AAC, and the reallocation of GA Surplus Notes by holders of outstanding GA Surplus Notes, to holders of Deferred Amounts. Specifically, on the Effective Date, AFG will transfer $129 million of GA Surplus Notes (which AFG currently holds),[14] and certain sponsoring General Account Surplus Note Holders will transfer $153 million of GA Surplus Notes to an escrow account. The resulting sum of $282 million of GA Surplus Notes will be transferred pro rata to beneficial Holders of an equal amount of Deferred Amounts. In return, Deferred Amount Holders will transfer a corresponding $129 million of DPOs to AFG, and $153 million of DPOs to the Sponsoring General Account Surplus Note Holders (the **"Initial Exchange"**).[15] The Rehabilitator will retain sole discretion to implement the Initial Exchange and determine the pro rata treatment among Holders affected by the Initial Exchanges. To illustrate, the Transaction Mechanics flow-chart filed with this Motion depicts the Initial Exchange in more detail.[16]

Immediately after the Initial Exchange is complete, all Holders of Pre-Record Date

[13] Figures in section B.(2) are projected for December 2017 and are thus approximations.

[14] All amounts cited are approximate.

[15] Third parties ultimately receive 40% cash on their original claim. The exchange details however are a bit more complex. In the Initial Exchange, they receive surplus notes equal to 12.5% of their claim. That exchange leaves 85% of their claim yet unsatisfied. Forty percent of the original claim is equal to 45.7% of the remaining 85% (.4 / .875) so they get paid cash equal to 45.7% of the 87.5% remaining (which equals 40%). The same is true for the Secured Note exchange, except that the final percentage of Secured Notes received per dollar of claim is 41%.

[16] Schwartzer Aff. at ¶ 11, incorporating the Transaction Mechanics slides dated September 30, 2017 as Exhibit A.

Deferred Amounts (except for AFG) will receive, on account of such Pre-Record Date Deferred Amounts, their pro rata share of Cash and Senior Secured Notes, based upon the formula set forth in the Second Amended Plan. As a result of this distribution, together with the consideration received in the Initial Exchange, Holders of Pre-Record Date Deferred Amounts will effectively receive the following consideration: (1) 40% of Deferred Amounts will be paid by AAC in Cash; (2) 41% of Deferred Amounts will be paid by AAC with Senior Secured Notes (together with Cash comprise the "**Deferred Amount Consideration**"); (3) 12.5% of the Deferred Amounts will be exchanged with AFG and the Sponsoring General Account Surplus Note Holders for Surplus Notes that remain outstanding after the Effective Date; and (4) the remaining 6.5% of the Deferred Amounts will be satisfied and discharged (the "**Discharged Deferred Amount**"), as an offset against any accrued Accretion Amounts. [17]

The Senior Secured Notes will be issued to Pre-Record Date Deferred Amount Holders by a new affiliate of AAC, created especially for this purpose. This AAC affiliate will pledge all of its assets as collateral for the Senior Secured Notes, which includes a separate secured note issued by AAC (in identical principal amount as the Senior Secured Notes) to the affiliate which will in turn be secured by: (a) the first $1.4 billion of any proceeds recovered by AAC through the RMBS Litigation; (b) AAC-owned RMBS investment assets with a market value of at least $350 million; and (c) the proceeds of AAC's Senior Secured Notes. AAC will also issue a financial guaranty policy that guarantees timely payment of principal and interest on the Senior Secured Notes. In the event that Ambac or the Segregated Account receives proceeds from any RMBS Litigation on or before the Effective Date, such proceeds will be paid on a pro rata basis to Holders of Deferred Amounts, taking into account the pledge by AAC of any proceeds it would have received through its ownership of Senior Secured Notes, and will reduce the

[17] To reiterate, all principal on policy claims will be paid *in full*.

principal balance of the Senior Secured Notes accordingly. Upon closing of this Transaction, the Segregated Account will then be merged with and into AAC on the Effective Date (the "**Merger**").

In the Rehabilitator's judgment, the Senior Secured Notes are superior to the existing Deferred Amounts and GA Surplus Notes, and such notes are thus "cash equivalent" based on the following:

(1) The Senior Secured Notes offer a higher rate of interest (LIBOR plus 5%, with a 1.0% floor) than the prevailing accretion rate on Deferred Amounts.

(2) The Senior Secured Notes are secured by a pledge of prospective RMBS Litigation recoveries and $350 million of AAC's RMBS investment assets. The Senior Secured Notes are also covered by an AAC financial guaranty policy insuring timely payment of principal and interest. In the event that Ambac or the Segregated Account receives proceeds from any RMBS Litigation on or before the Effective Date, such proceeds will be paid on a *pro rata* basis to Holders of Deferred Amounts, and will reduce the principal balance of the Senior Secured Notes accordingly.

(3) The Senior Secured Notes have a five-year maturity, but are subject to mandatory redemption upon receipt of RMBS Litigation proceeds; the Senior Secured Notes may thus be paid in full before their stated maturity. It should also be noted that, unlike the Deferred Amounts and GA Surplus Notes, payments on the Senior Secured Notes are **not** subject to OCI approval but rather are a function of the terms of the Notes.

AFG also holds Deferred Amounts, SA Surplus Notes and GA Surplus Notes but, to facilitate the Transaction, agreed to receive no cash consideration. AFG will receive only additional Senior Secured Notes in full satisfaction of the Pre-Record Date Deferred Amounts it

holds (including Deferred Amounts it received in the Initial Exchange), and retain GA and SA Surplus Notes. Specifically, AFG will receive 0% cash and 52% in Senior Secured Notes, while third party Deferred Amount holders will receive 81% in cash and Senior Secured Notes. As noted, AFG will retain Senior Surplus Notes that are subject to significant transfer restrictions not applicable to third parties. No accretion (nor any interest) shall be paid to any Deferred Amount holder on account of Pre-Record Date Deferred Amounts for the period from the Record Date until payment.

(3) Class 3 – General Claims. There is no distribution afforded to Holders of General Claims under the Second Amended Plan.

(4) Class 4 – Reconciliation Claims. The reconciliation of Deferred Loss Amounts is unnecessary under the Second Amended Plan, and as such, this Class has been removed from treatment under the Second Amended Plan. Reconciliations of claim amounts will be managed by AAC after the Initial Exchange anticipated under the Second Amended Plan.

(5) Class 5 – Segregated Account Surplus Notes & Junior Surplus Notes. AFG is currently the only remaining Holder of Surplus Notes issued by the Segregated Account. As such, Section 2.05 of the First Amended Plan has been deleted in its entirety and the Segregated Account will have no obligations to pay Segregated Account Surplus Note Holders *pari passu* with DPO Holders under the Second Amended Plan. AFG executed the RESA and thus consents to the Second Amended Plan and the treatment of its Segregated Account Surplus Notes. The Segregated Account Surplus Notes will remain outstanding after the Effective Date, with AAC as the only obligor as a result of the Merger.

The Junior Surplus Notes will not be entitled to any payment or other consideration from the Segregated Account pursuant to the Second Amended Plan. The Junior Surplus Notes,

however, will remain outstanding after the Effective Date. AAC will become the obligor of the Junior Surplus Notes as a result of the Merger.

C. Conditional Changes to the Payment Guidelines Are Being Made to Facilitate a Timely Closing of the Transaction

In the Amended Plan, the Court granted the Rehabilitator sole and exclusive discretion to amend the Payment Guidelines. Specifically, the Amended Plan provides in part that: "[T]he Rehabilitator has the authority to issue to all interested Persons guidelines or further directions as may be necessary or appropriate from time to time in his sole and absolute discretion in order to carry out the purposes and effects of this Plan and the Payment Guidelines."[18] Pursuant to that authority, the Rehabilitator has issued amended Payment Guidelines for the Second Amended Plan of Rehabilitation that, in general, provide for the following:

- Establishes a "Record Date" of September 30, 2017;[19]
- Sets a Presentation Deadline for Pre-Record Date Claims of November 30, 2017;[20] and,
- Shortens the Reconciliation Periods to file Oppositions to Proposed Claim Payments and sets an outer deadline by which a Holder must file a Disputed Claims with the Rehabilitation Court of twenty (20) days following receipt of a Reconciliation Response.

In the Rehabilitator's judgment, these shortened deadlines are necessary to allow for a timely closing of the Consensual Transaction after a full review of claims and reconciliation of disputed

[18] *See* Amended Plan, § 3.02, p. 17; *see also* Payment Guidelines, as Amended, § 5.5, p. 15 ("Upon written notice by the Rehabilitator or his counsel to all parties included on the Court-approved electronic service list and a posting on the Website, these Payment Guidelines may be supplemented, modified, altered or withdrawn in the Rehabilitator's discretion.").

[19] The Record Date is the cut-off date established by the Payment Guidelines, as amended, and consistent with the RESA, as amended, to determine which policyholders are eligible to receive the consideration package set forth in the Consensual Transaction.

[20] Claims that arise prior to the Record Date must be tendered to Ambac on or before November 30, 2017; that represents a claims presentation period of no less than 60 days, which is shortened from 120 days under the current version of the Payment Guidelines. Historically, however, claims have been presented monthly (*i.e.* within 30 days or shortly thereafter), so in the Rehabilitator's judgment, reducing the claims presentation period does not impose an undue burden on Trustees or policyholders.

claim amounts, but without imposing an undue burden on Trustees or policyholders.

To be clear, full implementation of the amended Payment Guideline and Second Amended Plan is conditioned on this Court's approval of the Second Amended Plan. That is, policyholders with claims that arise *before or after* the Record Date will continue to receive 45¢ per dollar of claim value in cash and 55¢ in a Deferred Amount. If and only if this Court approves the Second Amended Plan will the terms of the Consensual Transaction be carried out whereby Pre-Record Date holders of Deferred Amounts will receive the package of Senior Secured Notes and cash as consideration and Post-Record Date Deferred Amount holders will receive an additional 55¢ in cash per dollar of claims.

IV. STANDARD OF REVIEW: THE REHABILITATOR IS AFFORDED BROAD DISCRETION TO IMPLEMENT THE SECOND AMENDED PLAN

A. The Second Amended Plan Must Be Confirmed, Absent An Abuse of Discretion by the Rehabilitator

The process to rehabilitate an insurer is a regulatory proceeding undertaken to "reform and revitalize" the insurer. *See, e.g., Nickel v. Wells Fargo Bank*, 2013 WI App 129, ¶¶ 12 and 14, 351 Wis. 2d 539, 841 N.W.2d 482 ("Subject to court approval, the rehabilitator may take the action he or she deems necessary or expedient to reform and revitalize the insurer")(citing Wis. Stat. 645.33 (2)). Specifically, the Wisconsin Insurers Rehabilitation and Liquidation Act grants a rehabilitator "full power to direct and manage, to hire and discharge employees subject to any contractual rights they may have, and to deal with the property and business of the insurer." *Id.* ¶ 14 (quoting Wis. Stat. § 645.33(2)). A rehabilitation proceeding is thus not civil litigation. *Id.* ¶ 113 ("The rules of civil procedure, including the rules pertaining to discovery, do not apply to rehabilitation proceedings because ch. 645 prescribes its own rules of procedure in insurer delinquency proceedings. *See* Wis. Stat. § 645.33(5)."). *See* Wis. Stat. Ann. § 645.01 cmt. to subdiv. (4)(b) ("Rehabilitation should emphasize the management process, not the legal process.

Flexibility, informality and expertise should be encouraged, as they are in this chapter."); Wis. Stat. Ann. § 645.32 cmt. (noting that "the rehabilitator is given broad powers" and "the court's control should be liberal, not strict, and should be provided without cumbersome procedures"). In carrying out a review of the regulator's actions, a court must uphold the rehabilitator's determinations unless the rehabilitator abused his or her discretion. *Id.* ¶ 18.[21]

This motion concerns the Rehabilitator's discretion (*i.e.* business judgment) to determine whether, as a factual matter, the statutory standards in § 645.35 (2) have been met to allow the Segregated Account to exit from Rehabilitation. The Rehabilitator has concluded through a rational and transparent process that the Second Amended Plan, and the Consensual Transaction that the amendments are designed to facilitate, fulfills the purpose of the Rehabilitation and, in doing so, advances the broader interests of policyholders, creditors, and the public as a whole.[22] As set forth below, in particular in the affidavit of the SDC and the Expert Report, these conclusions and the merits of the Second Amended Plan are supported by credible evidence. *Nickel*, 351 Wis. 2d 539, ¶ 28 (finding that testimony from Rehabilitator was "particularly credible and . . . established that the commissioner appropriately exercised its discretion in

[21] The appellate court in *Nickel* applied an abuse of discretion standard to the Rehabilitator's factual determinations and further concluded that the great weight standard of review applied to issues of statutory interpretation in that case. *Nickel*, 351 Wis. 2d 539, ¶¶ 19-22. This Court need only apply the abuse of discretion standard here; there are no issues of statutory interpretation. We note however that the deferential standard that applies to court review of an agency's statutory interpretation is the subject of two cases pending review in the Wisconsin Supreme Court: *Tetra Tech EC, Inc. v. Wis. Dep't of Revenue*, 2017 WI App 4, 373 Wis. 2d 287, 890 N.W.2d 598 and *Wis. Dep't of Workforce Dev. v. Wis. Labor & Indus. Review Comm'n*, 2017 WI App 29, 375 Wis. 2d 183, 895 N.W.2d 77. The issue granted review by the Court is, "[d]oes the practice of deferring to agency interpretations of statutes comport with Article VII, of Section 2 of the Wisconsin Constitution, which vests the judicial power in the united court system?" The Court in those cases may decide to require application of the statutory "due weight" standard found in Wis. Stat. § 227.57, instead of the great weight standard. As neither standard applies here, the outcome of those cases therefore should have no bearing on this Court's consideration of the Motion.

[22] In reaching its holding that the Wisconsin standard for approval of a plan is "the broader interests of the policyholders, the creditors, and the public as a whole," the *Nickel* court specifically rejected arguments that the United States Supreme Court's decision in *Neblett v. Carpenter*, 305 U.S. 297 (1938) (affirming *Carpenter v. Pac. Mut. Life Ins. Co.*, 74 P.2d 761, 778 (Cal. 1937)), establishes a liquidation value baseline for rehabilitation plans. *See Nickel*, 351 Wis. 2d 539, ¶ 65 (citations omitted).

formulating a plan that was 'fair and equitable' and in 'the best interest of the[] policyholders'"); *see also Minor v. Stephens*, 898 S.W.2d 71, 76 (Ky. 1995) (stating that the rehabilitator "has no special interest in the outcome except to administer the matter for the maximum benefit of all interested parties").

The Second Amended Plan provides for fair and equitable treatment of claims of the Segregated Account, stabilizes the General Account and ends this Rehabilitation. Given these facts, the Rehabilitator's determination that the Consensual Transaction will result in a durable exit of the Segregated Account from Rehabilitation is not "arbitrary, capricious or an abuse of discretion" and as such, the Court should defer to the Rehabilitator's judgment that the Second Amended Plan is "fair and equitable" to all parties concerned. *See LaVecchia v. HIP of N.J., Inc.*, 734 A.2d 361, 364 (N.J. Super. Ct. Ch. Div. 1999). It is axiomatic, therefore, that the Second Amended Plan should be approved. *See Nickel,* 351 Wis. 539, ¶¶ 90-91 ("it is axiomatic that the commissioner, in the reasonable exercise of the state's police power, may structure a rehabilitation plan that has the potential to adversely affect the interests of individual policyholders when the plan advances the broader interests of the policyholders, the creditors, and the public as a whole")(citations omitted); *see also In re Dinallo v. DiNapoli*, 877 N.E.2d 643, 644 (N.Y. 2007); *In re Mills v. Florida Asset Fin. Corp.*, 818 N.Y.S.2d 333, 334 (App. Div. 2006).

B. The Rehabilitator is Entitled to Rely on Professional Advisors in Exercising His Business Judgment to Proceed with the Second Amended Plan

Section 645.33(3) of the Wisconsin Statutes makes clear that "the rehabilitator may consult with and obtain formal or informal advice and aid of insurance experts." *Nickel*, 351 Wis. 2d 539, ¶ 14. The Rehabilitator's decision here that the Consensual Transaction facilitates a durable exit from Rehabilitation was made "after substantial assistance from highly regarded

experts in the insurance and finance industries" that the Rehabilitator retained to, among other things, analyze the Transaction and test the durability of the result. *Nickel*, 351 Wis. 2d 539, ¶ 44; *see also Minor*, 898 S.W.2d at 77 ("[I]n the course of rehabilitation efforts, the Commissioner acted on advice from legal, accounting and actuarial experts"); *Ario v. Fid. Mut. Life Ins. Co*, 935 A.2d 55, 57 (Pa. 2007) (describing plan approval based on review of testimony and evidence from "insurance industry experts" the commissioner relied on, including a "professional provider of strategic advisory and capital raising services, with extensive business valuation, merger and acquisition, and capital restructuring experience"); *Kueckelhan v. Fed. Old Line Ins. Co.*, 444 P.2d 667, 675 (Wash. 1968) (evaluating and approving a rehabilitation plan "supported by respectable expert testimony").

The Rehabilitator also relied on the advice and calculations performed by the insurer's investment bankers, financial consultants, and other professionals to the extent such information was useful in evaluating the Transaction. *See Koken v. Fid. Mut. Life Ins. Co.*, 907 A.2d 1149, 1155 (Pa. Commw. Ct. 2006) (Rehabilitator relied, in part, on the advice of the insurer's experts). The Rehabilitator's judgment is that, after considerable analysis and months of consultations with experts, the Consensual Transaction, incorporated into the Second Amended Plan, results in a durable exit of the Segregated Account from Rehabilitation. The Plan thus achieves the purpose of the Rehabilitation and serves the best interests of policyholders.

C. The Court Retained Jurisdiction to Confirm the Second Amended Plan and Issue an Exit Order

Section 10.04 of the First Amended Plan (and the Initial Plan) specifically permits the amendments for which approval is sought by this Motion. That section provides, in relevant part that:

10.04 Amendment and Modification of this Plan.

> ... Following the Confirmation Date, the Rehabilitator may seek the approval of the Court to alter, amend, or modify this Plan or the Plan Documents with such notice and hearing as the Court prescribes pursuant to Wis. Stat. § 645.33(5).

These proceedings are governed by Wis. Stat. ch. 645. Pursuant to the authority granted by the statutes, this Court previously approved the Plan and a First Amended Plan and, in so doing, retained jurisdiction. Specifically, this Court retained jurisdiction under § 6.01 of the First Amended Plan to "modify this Plan" and "enter an order closing these Proceedings." This Motion seeks orders from the Court pursuant to that authority.

V. ARGUMENTS IN FAVOR OF APPROVING THE SECOND AMENDED PLAN

A. The Second Amended Plan Satisfies The Wisconsin Standards to Allow the Segregated Account to Exit Rehabilitation

Pursuant to § 645.01 of the statutes, the purpose of these Rehabilitation proceedings is to protect "insureds, creditors, and the public generally." *See* Wis. Stat. § 645.01(4); *Nickel*, 351 Wis. 2d 539, ¶ 90. To carry out this purpose under the statute, the Rehabilitator may:

> [T]ake the action he or she deems necessary or expedient to reform and revitalize the insurer. The rehabilitator shall have all the powers of the officers and managers. . . . The rehabilitator shall have full power to direct and manage . . . and to deal with the property and business of the insurer.
>
> * * * *
>
> [P]repare a plan for the reorganization, consolidation, conversion, reinsurance, merger, or other transformation of the insurer. . . . If it is approved [by the Court], the rehabilitator shall carry out the plan.

Wis. Stat. §§ 645.33(2) and (5); *Nickel*, 351 Wis. 2d 539, ¶ 14. This statutory purpose is fulfilled by first satisfying existing obligations to Deferred Amount beneficiaries of the Segregated Account and GA Surplus Note holders fairly and equitably under the circumstances.

The Rehabilitator has judged the Consensual Transaction in the Second Amended Plan as fair and equitable to such beneficiaries and holders based on the following, which is supported

though the conclusions drawn by Mr. McGettigan in his Expert Report:

- The present value of the *consideration* distributed to Deferred Amount beneficiaries and Surplus Note holders is *greater than* the present value of the prospective recovery available to such parties under the Status Quo (even assuming hypothetical aggressive increases in the IPP);

- The consideration provided to third parties is *superior to* the existing Deferred Amounts and GA Surplus Notes, as the Consensual Transaction provides third parties with cash and Senior Secured Notes that, unlike the existing Deferred Amounts and GA Surplus Notes, are almost entirely insulated from further potential adverse developments in AAC's insured portfolio; and

- The incremental benefits associated with cash payment in full in respect of claims presented after the Record Date represents a *material benefit* for many policies with Deferred Amounts outstanding that would not be possible in the absence of the Consensual Transaction.[23]

Given these facts, the Rehabilitator's determination to proceed with the Second Amended Plan is not "arbitrary, capricious or an abuse of discretion" and as such, the Court should defer to the Rehabilitator's decision and find that is "fair and equitable" to all parties concerned. *See LaVecchia v. HIP of N.J., Inc.*, 734 A.2d 361, 364 (N.J. Super. Ct. Ch. Div. 1999).

The Rehabilitator has also decided the Second Amended Plan will ease the cost and administrative burden of the Rehabilitation proceedings, make no material alterations to claims or reclassify claimholders, enable the Rehabilitator (and OCI post-exit) to more effectively manage immediate and future distributions, and close these Rehabilitation proceedings. This is because, since these proceedings commenced, the majority of the identified financial and operational risks that are subject to remediation in the Rehabilitation have been resolved. The Rehabilitator has thus decided the stability and viability of the Segregated Account has been fairly established.

These fact-based determinations of the Rehabilitator are reviewed by this Court for an

[23] McGettigan Expert Report at p. 11.

abuse of the Rehabilitator's discretion. *Nickel,* 351 Wis. 2d 539, ¶ 18. As noted by the Court of Appeals in this case, rehabilitation matters should "maximize the commissioner's flexibility in formulating a rehabilitation plan tailored to the circumstances of the particular case. . . ." *Id.* ¶ 69. It was "readily apparent" that the commissioner may contemplate "adjust[ing] payments under the Surplus Notes" including "modify[ing] the scheduled maturity date and making adjustments where needed to protect the interests of policyholders. . . ." *Id.* ¶ 130. The ultimate goal is to "reform and revitalize" the insurer, and in doing so, the Rehabilitator "may take the action he or she deems necessary or expedient" in doing so. Wis. Stat. § 645.33(2). The proposed Second Amended Plan is precisely the type of discretionary action contemplated by the statute for the Rehabilitator to carry out its duties to fairly and equitably resolve claims.

Once the Rehabilitation has been accomplished and outstanding obligations are satisfied or accounted for, the Rehabilitator may then terminate a rehabilitation proceeding when "[the] grounds for rehabilitation under s. 645.31 no longer exist." *See* Wis. Stat. § 645.35(2). After the Consensual Transaction closes, the Rehabilitator and its financial advisor have determined that AAC will be able to pay all prospective policy claims in full and in cash, while also maintaining a sufficient buffer, or margin of safety, so that AAC will be able to maintain payment in full.[24] Those fact-based determinations must also be upheld, absent an abuse of discretion.

Ongoing liabilities post-exit will be assumed by AAC, claims will be paid in full and the need for any further rehabilitation of the Segregated Account will end. The reason for the Rehabilitation – namely AAC's inability to pay claims in full when presented, thus, no longer exists. Under § 645.35(2), by restoring AAC's future claims paying ability, the "grounds for rehabilitation no longer exist." The Consensual Transaction in the Second Amended Plan therefore satisfies the two part exit standard of Wis. Stat. § 645.35(2) – that the rehabilitation has

[24] McGettigan Expert Report at p. 19.

been accomplished and the grounds for rehabilitation no longer exist.

B. The Second Amended Plan is in the Best Interests of Policyholders

1. The Second Amended Plan is Fair and Equitable Because it is Superior to the Status Quo and, On Balance, is in the Best Interests of All Policyholders, Creditors and the Public Generally

The Rehabilitator believes that the Second Amended Plan is in the best interests of policyholders, creditors and the public as a whole, and therefore complies with the standards for approval. The Second Amended Plan fairly and reasonably balances the interests represented by both the Segregated Account and the General Account, and is in all constituent parties' interests when compared to continuation of Rehabilitation. *See Nickel*, 351 Wis. 2d 539, ¶ 127 (court was "satisfied that the circuit court properly determined that the commissioner acted reasonably in balancing the competing interests of short-term and long-term policyholders"). Based on the Rehabilitator's financial analysis, continuing to operate under the terms of the existing Plan over a 37 year run-off after all underlying policies come to term, may result in an average present value payout ranging from approximately 75% to 78% for DPOs and GA Surplus Notes, which is less than the present value of the package of consideration to be distributed under the Second Amended Plan. The Second Amended Plan thus eliminates the continued financial risks associated with runoff.

First, it provides for an up-front payment of 40% of the outstanding claim amounts in cash. Senior Secured Notes and GA Surplus Notes make up the balance of consideration. On the whole, it also provides policyholders with more in present value than they would receive in a run off that could occur in a continued Rehabilitation of the Segregated Account. More importantly, however, is that the discount being imposed (which is 6.5% based on the par amount of consideration received pursuant to the Consensual Transaction), will be charged against accretion on DPOs and interest on GA Surplus Notes, not the principal due on claims.

As a result, the Consensual Transaction is fair and equitable in its treatment of DPO and GA Surplus Note holders.[25]

Moreover, the Consensual Transaction is fair and equitable to all constituents as compared to continuation of Rehabilitation. *See Nickel*, 351 Wis. 2d 539, ¶ 128 (reasoning that "fair and equitable" means that all constituents must be treated fairly, and therefore "§ 645.01(4)(d) does not require that all policyholders receive the same treatment"). The *Nickel* court clarified that in this Rehabilitation, "fair and equitable" means that the interests of policyholders, creditors, and the public in general must be balanced. The court held that "the purpose of rehabilitation proceedings is not to make each policyholder whole but to apportion unavoidable losses in a manner that is fair and equitable to policyholders, creditors, and the public in general." *Id.* ¶ 90. Insurance cases involve varied interests – in the *Nickel* decision, these were long-tail claimants and short-tail claimants, and "neither extreme [was] satisfied by the intermediate balance struck by the rehabilitator pursuant to the [Initial] Plan." *Id.* ¶ 126. Nonetheless, the Appellate Court upheld this Court's approval of the Initial Plan because it balanced competing demands in a way that was fair to both. *Id.* The Second Amended Plan is likewise "fair and equitable to policyholders, creditors, and the public in general."

Deferred Amount holders will receive greater value for their Deferred Amounts, in present value terms, than if the Rehabilitation was to continue. In regards to the 6.5% discount, the Rehabilitator's Financial Projections indicate that if Rehabilitation was to continue, Deferred Amounts may not be paid in full in certain scenarios; this mitigates (to some extent) any "loss" of claim value from the discount. Certain Deferred Amount holders (with relative low Deferred Amounts and relatively high estimates of future claims) may also receive incremental benefits from the return to timely payment in full.

[25] McGettigan Expert Report at p. 12.

There is another critical benefit of the Consensual Transaction – the transition to payment in full in cash on all claims presented by policies currently allocated to the Segregated Account. Assuming a record date of September 30, 2017, 126 policies allocated to the Segregated Account are expected to generate net claims under the Rehabilitator's base case loss estimate, including 94 policies with Deferred Amounts outstanding. If the Segregated Account Rehabilitation is continued, policy beneficiaries would receive 45% of these future policy claims in cash and 55% in Deferred Amounts until and unless the Rehabilitator elects to increase the IPP. Under the Consensual Transaction, these policies would receive cash payment in full on future claims, either on the Effective Date (if the claim is presented after the Record Date but before the Effective Date) or in the ordinary course after the Effective Date.

The Second Amended Plan also preserves existing contract rights, including respecting the terms of the Bank Settlement Agreement. That Agreement created GA Surplus Notes, but also limited AAC's ability to issue additional surplus notes or fund payment of Segregated Account Surplus Notes. The Bank Settlement Agreement at the time it was signed was to provide assurance to the Banks that their GA Surplus Notes would be paid at least in equal proportions to any other future notes issued by AAC. These terms resulted in a large commutation of AAC's liabilities to a major group of stakeholders and, therefore, paved the way for rehabilitation and future payment of Segregated Account liabilities. The restrictive covenants of the BSA may however be waived by a majority in aggregate principal amount of General Account Note holders (excluding AAC- affiliated holders), which is the case pursuant to the RESA. The end result is that the proposed amendments and the Second Amended Plan do not interfere with AAC's rights and obligations under the Bank Settlement Agreement or any parties' rights under the GA or Segregated Account Surplus Notes. As such, the interests of

policyholders and other creditors are protected through the implementation of the Second Amended Plan.

The Rehabilitator and his advisors spent significant time analyzing and assessing various options to exit the Segregated Account from Rehabilitation and strongly prefers a consensual resolution to a non-consensual option that would have to be imposed on all parties.[26] In the Rehabilitator's view, the Second Amended Plan provides for exchanges that limit the financial risks borne by policyholders and other creditors, provides for a substantial upfront payment, eliminates the claims payment disparity between the General and Segregated Accounts, and preserves the going concern value of AAC. On balance, therefore, the Consensual Transaction is superior to the status quo - or any other option - and is fair and equitable because it balances the interests of all constituents of AAC and the Segregated Account.

2. The Second Amended Plan Meets the Rehabilitator's Durability Requirement

a. The Margin of Safety is a Key Durability Measure to Address Anticipated Risks in the General Account

The Rehabilitator has always maintained that any amended Plan or exit strategy must be durable.[27] To be durable, any plan to exit Rehabilitation must be able to stand the test of time. In this case, the estimated future financial condition of AAC must allow for the payment of future policy claims in full. The Rehabilitator and its advisors are familiar with AAC's insured portfolio risks, loss mitigation strategies and potential sources of value, among other factors, and have used this knowledge to determine appropriate parameters for this Transaction. In addition to modeling the Transaction against stress case scenarios, the Rehabilitator has also built in a

[26] Schwartzer Aff. at ¶¶ 7-9.

[27] *Id*.

material financial margin of safety — above and beyond any claims-paying resources contained in its stress case scenarios. The margin of safety has been modeled and reviewed by the Rehabilitator's advisory team, who have accounted for various anticipated "stress case" risks, including the primary ones described below.[28]

b. The Rehabilitator Has Accounted for Anticipated Risks[29]

i. Puerto Rico

The Commonwealth of Puerto Rico and a number of its instrumentalities are in "bankruptcy."[30] The chain of events that led to bankruptcy began on July 1, 2016 when Puerto Rico defaulted on a portion of its general obligation bonds. AAC does not insure those bonds. However, AAC insures various *other* Commonwealth and municipal bond issuances in Puerto Rico, including capital accretion bonds, known as COFINA Bonds, in an original principal amount of $800 million that are paid with the proceeds of Puerto Rico's collection of sales and use taxes. One of the primary issues creating risk to the COFINA Bonds is whether or not revenue streams from sales and use taxes should be diverted to instead pay general obligation bondholders and other Commonwealth creditors. Accordingly, there is a risk as to whether or not AAC, upon the Court ordered dissolution of the Segregated Account and return of policies to the General Account, can meet its obligations regarding the COFINA Bonds and other Puerto Rico exposures under the stress case scenario.

The Rehabilitator and his advisors have given significant attention to the risks associated

[28] McGettigan Expert Report at pp. 20-23.

[29] As explained more fully in the Disclosure Statement, the Rehabilitator's financial analysis includes a conservative outlook and by its very nature contains estimates, projections, and assumptions; as such, there can be no guaranty that the proposed payments under the Second Amended Plan will be made.

[30] The debt restructuring process ongoing in federal court to adjust the Commonwealth's debts was filed pursuant to Article III of the Puerto Rico Oversight, Management and Economic Stability Act ("**PROMESA**"), enacted by Congress on June 30, 2016 and modeled after chapter 11 of the U.S. Bankruptcy Code.

with AAC's exposure in Puerto Rico, including the risk that losses may increase significantly in the event revenue sources to AAC-insured debt receives significantly lower than projected recoveries.[31] As a reaction to the financial concerns in Puerto Rico, the Rehabilitator's advisors have increased stress case scenario loss estimates, which have correspondingly increased claims paying resources needed to meet the baseline for the required margin of safety in the Second Amended Plan.[32] Despite these risks, and given the increase in required claims paying resources, the Second Amended Plan meets the Rehabilitator's conservative requirements.

ii. Military Housing

AAC insures nearly $6 billion of debt obligations involving the construction and renovation of housing units on bases of the United States Army, Navy, Marines and Air Force. From time to time, the U.S. Congress authorizes the closure or realignment of military installations through a process known as Base Realignment and Closure ("BRAC"). In 2005, a commission tasked with evaluating a BRAC throughout the nation made recommendations that Congress authorize realignment and closure of various bases at that time, and that another BRAC round be conducted in 2015 (although this recommendation was ignored and no BRAC was held in 2015). The 2005 BRAC process did not have a material impact on AAC's insured military bases. There is nevertheless a risk that a future BRAC round would lead to a base closure or reduction in troops that adversely impacts one or more military bases at which AAC insures housing project debt.[33] Although the housing units could be repurposed to mitigate losses, such

[31] McGettigan Expert Report at pp. 20-23.

[32] *Id.*

[33] McGettigan Expert Report at p. 23, n. 28 ("While Secretary of Defense Mattis supported a BRAC for 2021, both the House of Representatives and the Senate have passed versions of the 2018 National Defense Authorization Act that do not contemplate a new BRAC round" thus it is reasonable to assume that the earliest recommendations from a BRAC could become official would be 2022).

closure or troop reduction could negatively affect the ability of insured housing projects to meet debt service requirements. Collectively, the loss projections and margin of safety adequately account for this risk.[34]

Further, the anticipated Final Order of the Court that will merge the Segregated Account back into the General Account, will also eliminate any alleged defaults under General Account policies. Specifically, there are seven (7) cases in various states currently pending against the General Account in which parties opposed to Ambac have alleged a "default" under housing project transactional documents associated with Ambac's policies. In each case, Ambac provided credit enhancements through financial guaranty policies and, in so doing, the loan documents granted to Ambac the rights of the Senior Lender. The parties opposed to Ambac argue that, as a result of the Segregated Account being placed into rehabilitation, and particularly as a result of the manner in which the Segregated Account was capitalized, this Court's Plan of Rehabilitation is an event of default because the Plan constitutes an Order "appointing a custodian, trustee, agent or receiver for Ambac or for all or a material portion of its property" or "authorizing the taking possession by a custodian, trustee, agent or receiver of Ambac (or taking of possession of all or any material portion of Ambac's property)." AAC denies these allegations and the Rehabilitator agrees that no such events occurred. Standard remedial language in the Final Order will resolve the issues by deeming all claims paid in full, all alleged defaults cured (to the extent they ever existed), and all obligations fully satisfied upon closing of the Consensual Transaction. As a result, the conclusion of these proceedings should alone eliminate the legal dispute over this issue.

iii. Tax Issues

The Rehabilitator has considered whether the proposed Second Amended Plan and the

[34] McGettigan Expert Report at p. 22-23.

Initial Exchange would have the potential to result in adverse tax consequences for Ambac and/or Holders of Deferred Amounts. The Rehabilitator's tax advisors have analyzed the Second Amended Plan and the Initial Exchange to determine whether and to what extent any of the following potential tax consequences may be implicated:

- Impairment, whether in the form of a limitation on use or reduction, of AAC's U.S. federal net operating loss carryforwards ("**NOLs**");
- The proposed Second Amended Plan and the contemporaneous voluntary exchange of GA Surplus Notes will cause AAC to recognize a considerable amount of taxable income and require AAC to make a tolling payment to AFG under the existing tax sharing agreement between AAC and AFG; there may also be going-forward tax consequences, with associated tolling payments, due to the loss of tax deductions attributable to accretion on Deferred Amounts;
- Adverse tax treatment accorded to the Holders of Deferred Amounts under the Proposed Plan; and
- Impairment or disqualification of the favorable tax consequences enjoyed by Ambac under the favorable Internal Revenue Service ("**IRS**") private letter ruling that Ambac obtained in 2013 relating to the Deferred Amounts.

The Rehabilitator and his advisory team reviewed materials provided by AAC, and held discussions with AAC and its tax advisors; further, the Rehabilitator's financial advisors have independently researched and analyzed various issues.

AAC has structured the Initial Exchange and the terms of the Senior Secured Notes to be issued under the Second Amended Plan in a manner that is expected to avoid jeopardizing the NOLs (that remain after offsets for taxable income resulting from the Amended Plan). Further, the financial projections and analysis performed by AAC's financial advisors support classifying the Senior Secured Notes as debt for federal income tax purposes. These factors, combined with a favorable receipt from the IRS of a second PLR (defined and described in further detail below), resolve the issue of impairment of the NOLs to the Rehabilitator's satisfaction.

The Rehabilitator and his advisory team have reviewed materials provided by AAC regarding the anticipated taxable income to AAC and tolling payment obligations resulting from the Second Amended Plan. These amounts are calculable and thus knowable. The required margin of safety takes these amounts into account.

The Rehabilitator and his tax advisors have also researched and analyzed the tax consequences to Holders of Deferred Amounts. The Initial Exchange is expected to be treated as a sale or exchange of the right to receive insurance proceeds represented by the Deferred Amounts. Although the consequences for a given Holder of Deferred Amounts will depend on the facts and circumstances of the particular Holder and may vary from Holder to Holder, generally, the following is expected: to the extent that the cash and Senior Secured Notes received by a Holder of Deferred Amounts pursuant to the Second Amended Plan does not exceed the amount of the policy claim giving rise to the Deferred Amount, such receipt is expected to be treated for tax purposes in the same manner as if the Holder received a payment of interest or principal (depending on the origin of their claim) on the insured bonds; to the extent the Holder receives more cash and Senior Secured Notes than the amount of the policy claim giving rise to the Deferred Amount, the amount attributable to accretion on the Deferred Amount is expected to be treated as ordinary interest income; and to the extent the Holder receives less than the full amount due on its policy claim, the Holder is expected to be eligible to claim whatever losses would be deductible if the original bond issuer defaulted and paid less than the amount due.

Going forward, the Deferred Amount Holders may have imputed interest income without the receipt of cash (*i.e.*, for original issue discount on Surplus Notes received in the Second Amended Plan). In any case, the Rehabilitator expects that the Cash and Senior Secured Notes

received upfront by the Deferred Amount Holders in the Second Amended Plan should be sufficient to cover any current and future income tax liability to Holders resulting from the Second Amended Plan. Accordingly, the Rehabilitator believes that Holders of Deferred Amounts are treated reasonably in the Second Amended Plan from a U.S. federal income tax perspective.

On May 12, 2017, the IRS held a pre-submission conference with AAC and its tax advisors to discuss certain issues related to AFG's request for another private letter ruling (the "**PLR**"), this time seeking to determine certain tax ramifications of the Second Amended Plan and the proposed Consensual Transaction. On July 26, 2017, AFG submitted to the IRS a formal request for a PLR concluding that certain exchanges contemplated by the Second Amended Plan and the proposed Consensual Transaction will not be treated as "designated events" for purposes of IRS Notice 2004-37. Those exchanges include: (1) AAC's issuance of the Senior Secured Notes (and other consideration) in exchange for the outstanding GA Surplus Notes; (2) AAC's issuance of the Senior Secured Notes (and other consideration) in exchange for the satisfaction of the Deferred Amounts owed by the Segregated Account; and (3) AAC's exchange of certain bonds issued by third parties and insured by AAC (which following amortization or write-off in accordance with the terms of the bonds, currently have no economic value aside from the Deferred Amounts associated with such bonds) for outstanding GA Surplus Notes.

The Second Amended Plan is contingent upon receiving a favorable PLR from the IRS, providing rulings substantially as requested. The IRS's determination has not yet been conveyed to AAC. The Rehabilitator expects that AFG will receive a favorable determination from the IRS before the hearing scheduled in this matter commencing on January 4, 2018. As such, the Rehabilitator has decided to move forward and seek this Court's approval of the Second

Amended Plan at this time, given the deadlines required by the Ad Hoc Group to consummate the Consensual Transaction.[35]

3. Factual Developments Confirm the Rehabilitator's Judgment That the Second Amended Plan is Durable and Meets the Standards for Approval

a. The Market Reacted Favorably to the Consensual Transaction

The proposed Consensual Transaction has received considerable support from the investing public and the marketplace. Upon the July 19, 2017 announcement of the proposed Consensual Transaction, the trading value of Ambac's Surplus Notes immediately increased by 2.6%, and this increase has been generally maintained through the date of the filing of this motion. The market reaction reflects a positive opinion of the proposed Consensual Transaction — both for the holders of the Surplus Notes (and by proxy the DPO holders), and for Ambac. While a portion of this reaction may reflect the market's positive view of *any* agreement that exits the Segregated Account from Rehabilitation, the fact of an increase in trading value upon announcement and maintenance of an increased value thereafter should not be ignored. Also, the absence of an adverse reaction with respect to certain distressed bonds with policies allocated to the General Account is noteworthy from a durability perspective.[36]

In addition, there has been excess demand by the investment community for the Tier 2 Notes. This excess demand is ratification by the market of both the Consensual Transaction in general and AAC's valuation of its potential RMBS Litigation recovery specifically. Pursuant to the proposed Consensual Transaction, the Tier 2 Notes are tied to the results of the RMBS Litigations; the Tier 2 notes may be paid with RMBS Litigation proceeds that exceed $1.6

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[35] The Rehabilitator and his tax advisors have analyzed the consequences of the Second Amended Plan upon the 2013 IRS private letter ruling and believe the Second Amended Plan does not risk the viability of that ruling.

[36] McGettigan Expert Report at p. 25.

billion. The enthusiasm of potential purchasers indicates that sophisticated investors, with access to all public information about AAC, the Rehabilitation, the proposed Consensual Transaction and the RMBS Litigations, have generally determined that Ambac's interest in RMBS recoveries has substantial value sufficient to warrant an investment in the proposed Tier 2 Notes.[37] While all litigation is by nature uncertain, this determination made by disinterested, unrelated and sophisticated investors bears weight with respect to the likelihood of success and recovery in RMBS Litigations.

b. Claimholders Support the Second Amended Plan

The Ad Hoc Group, comprised of representatives of four major hedge funds and a fifth fund that consented to the Transaction after the terms were agreed upon, have all provided an Affidavit of support for the Consensual Transaction.[38] Together, these 5 funds hold the majority of Deferred Amounts and, as a result of trading, additional funds have signed a joinder thus increasing the percentage of support among creditors. Including amounts held by AFG and AAC, approximately 61% of the holders of all outstanding Deferred Amounts and in excess of 60% GA Note holders have consented in writing to the Second Amended Plan.

c. Risk Mitigation and Commutations

AAC has been and continues to pursue a number of de-risking activities, including mitigation of tail risk exposures on COFINA bonds and other Puerto Rico obligations, commutations of student loan obligations, and litigation settlement with Ballantyne RE plc (through Ambac Assurance UK Limited), among others. These projects include working closely with stressed issuers to facilitate refinancing; re-shaping its interest rate swap exposure to mitigate the risk of increased loss development due to a spike in interest rates; pursuing

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[37] McGettigan Expert Report at p. 9.

[38] *See* Pfeiffer Aff., ¶ 8.

strategies to enhance the financial wherewithal of Ambac Assurance UK Limited; developing a revised investment portfolio allocation to be implemented after the Transaction is consummated; and restructuring business operations to reduce operating expenses.

4. RMBS Litigation Proceeds Will Be Sufficient To Cover Payments To Be Made Under the Consensual Transaction

AAC and the Segregated Account are parties to litigation in multiple jurisdictions involving AAC's policies written on RMBS securities which were allocated to the Segregated Account (the "**RMBS Litigations**"). In those cases AAC and the Segregated Account have asserted causes of action, including breach by banks and mortgage loan originators of repurchase obligations, breaches of contract, fraudulent inducement and indemnification and/or reimbursement of costs. The RMBS Litigations include:

- *Ambac Assurance Corp. v. First Franklin Financial Corp.*, Index No. 651217/2012 (N.Y. Sup. Ct.);
- *Ambac Assurance Corp. v. Countrywide Securities Corp. and Bank of Am. Home Loans*, Index No. 651612/2010 (N.Y. Sup. Ct.);
- *Ambac Assurance Corp. v. Nomura Credit & Capital, Inc.*, Index No. 651359/2013 (N.Y. Sup. Ct.);
- *Ambac Assurance Corp. v. Countrywide Home Loans and Bank of Am. Corp.*, Index No. 653979/2014 (N.Y. Sup. Ct.); and
- *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, No. 14-CV-3511 (Dane Cty. Cir. Ct.).

The potential recovery in these cases – which are being litigated in a mature legal environment in which other cases have been tried or resolved consistent with AAC's expectations – well exceeds the principal amount of the Senior Secured Notes distributed to third parties. These RMBS cases however are at differing stages of litigation, with the earliest filed nearly 7 years ago but still not

yet scheduled for trial.[39] The Senior Secured Notes effectively "bundle" the potential recoveries in the RMBS Litigations to provide valuable consideration to DPO holders now and allow for an exit from Rehabilitation rather than waiting for trial and any appeals.

AAC has asserted claims for over $2.0 billion in damages in one of the pending RMBS Litigations alone — *Countrywide Home Loans*, Index No. 651612/2010 (N.Y. Sup. Ct.) (Bransten, J. presiding) (the "**Countrywide**" case). In that case, AAC's expert has opined (in the court filings made part of the public record) that AAC's and the Segregated Account's damages as of October 2014 range from a low of $1.98 billion to a high of $2.203 billion.[40] Further, in AFG's Form 10-Q Quarterly Report, filed on August 9, 2017 for the period ending June 30, 2017, based on GAAP financial statements, AAC estimated the discounted value of potential recovery net of reinsurance is $1.857 billion in three of the RMBS Litigations above.[41] Lastly, RMBS counsel to the Segregated Account has also conducted a thorough valuation of the RMBS Litigations, which the Rehabilitator has considered in his analysis.[42] The RMBS Litigations therefore have been subject to due diligence review by qualified professionals and the Rehabilitator is thus confident that the estimates of potential RMBS litigation recoveries are

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[39] The complaint in *Ambac Assurance Corp. v. Countrywide*, Index No. 651612/2010, for example, was filed September 28, 2010.

[40] Schwartzer Aff. at ¶ 16, which incorporates copies of the expert reports as Exhibits D and E. These reports are being supplemented to address a ruling from the First Department (which is New York's intermediate appellate court), that affects AAC's ability to recover the $2.203 billion figure cited above. That ruling is on appeal and has been accepted for review by the New York Court of Appeals. In any event, there are other measures of damages not affected by the First Department's ruling that exceed $2 billion.

[41] Those three cases are: *First Franklin Financials Corp.*; *Countrywide Securities Corp.* (651612/2010); and *Nomura Credit & Capital, Inc.*

[42] The Rehabilitator relied upon litigation value assessments prepared by Patterson Belknap Webb & Tyler, LLC, which represents the Segregated Account in the RMBS cases. The purpose of referencing these assessments is to demonstrate to the Court that the RMBS Litigation portfolio has been subject to extensive analysis, which the Rehabilitator has considered in determining how to proceed. Counsel's analysis however is protected by the attorney client privilege and work product doctrine (Wis. Stat. § 905.03), the common interest privilege (*Id.*) and the OCI regulatory privilege (Wis. Stat. § 601.465); the Rehabilitator reaffirms it is asserting these privileges here.

reasonable.

In taking a conservative view of AAC's estimated value of the RMBS Litigations, the Rehabilitator, with his financial advisors, has allowed only $1.52 billion for the value of RMBS proceeds in its stress case durability scenarios to calculate the margin of safety and financial considerations of the Second Amended Plan. That amount is not a comment on the merits of the cases or the integrity of the damages analysis done by the expert witness in the Countrywide Case but rather reflects the Rehabilitator's cautious approach to this case. It also provides an additional cushion, or margin on the margin, of hundreds of millions of dollars that could, potentially, be realized through successful settlement or trial of all the RMBS Litigations. The Rehabilitator thus believes that the litigation or settlement value of these claims is more probably than not sufficient to support issuance of and sufficiently securitize the Senior Secured Notes.[43]

The Plan proposes to provide consideration to Deferred Amount beneficiaries and GA Surplus Note holders now, rather than waiting for RMBS Litigation proceeds to materialize and then pay the balance of policy claims at some unknown date in the future. Importantly, the Senior Secured Notes that will be issued and remaining GA Surplus Notes may be traded by investors. Thus, in the Rehabilitator's judgment, it is more probable than not (assuming markets develop for these securities as they have in the past), the Senior Secured Notes and GA Surplus Notes can be monetized, which is an additional benefit afforded to policyholders under the Second Amended Plan.

5. The Second Amended Plan Avoids Long-Term Runoff and Eliminates the Burden of Court Oversight that has Plagued Other Cases

Rehabilitation should be concluded when either the goals of rehabilitation have been

[43] Schwartzer Aff. at ¶ 16. In addition, as discussed previously, the Senior Secured Notes will *also* be secured by AAC-owned RMBS investment assets with a market value of at least $350 million, plus the proceeds of AAC's Senior Secured Notes. AAC will also issue a full-recourse financial guaranty policy on the Senior Secured Notes.

accomplished or when continuing rehabilitation proceedings would be futile. *See* 9 Jeffrey E. Thomas, *New Appleman on Insurance Law* § 100.08 (Library ed. 2017); *see also* Wis. Stat. §§ 645.35(2), 645.41(1). There are many benefits to approving the Second Amended Plan and exiting the Segregated Account from Rehabilitation now. As it currently stands, unless amended, the Plan would result in long-term runoff, with AAC's last policy obligations concluding in 2055. AAC has estimated the annual administrative cost of the Rehabilitation in a run-off scenario at over $6 million. Prolonging the Rehabilitation would continue this unnecessary expense with little benefit. A runoff also impedes AAC's ability to write new business, having an adverse impact on its ability to pay future claims. Simply maintaining the status quo of the existing Plan is thus counterproductive to generating and preserving claims-paying resources; and, given the benefits of the Consensual Transaction, would be at odds with the purpose and ultimate objective of this Rehabilitation.

There is also the issue of allocation of significant Court and administrative resources: in runoff situations, rehabilitation proceedings and oversight may continue indefinitely. *See, e.g., In re American Mut. Reinsurance Co.*, No. 88 CH 1595 (Cook Cty. Ill. Ch. Div. 1988) (rehabilitation remained open for over twenty years while administrative costs continued). As a result, rehabilitation courts, and regulators, prefer a definitive and durable exit from rehabilitation where possible. In *Grode v. Mutual Fire, Marine & Inland Ins. Co.*, 688 A.2d 233 (Pa. Commw. Ct. 1996), the insurer sought to end its 10-year rehabilitation proceeding by settling and discharging claims through an out-of-court repayment plan. As the court in *Grode* wrote:

> [D]istribution of estate assets of this significance would obviously not have been possible without extraordinary efforts to collect estate recoverables. Since submission of the 1989 plan of rehabilitation, and particularly in the years 1990 through 1996,

> reinsurance collections . . . have amounted to over $258 million. These collections were accomplished through negotiation, voluntary and Court-supervised settlements and, where necessary, litigation to trial.

Grode, 688 A.2d at 236. The court explained that as of the December 1996 order, Mutual Fire had collected enough funds to warrant a finding by the court that an exit was durable. *See id*. at 237. Although claims were not instantly paid in full upon exit, the court believed that ending the rehabilitation proceeding was warranted under the circumstances.

Even in complex cases where emergence from rehabilitation requires difficult choices, other rehabilitators and insurers have attempted to avoid continuing costs and administrative oversight through settlement, uniquely structured rehabilitation plans, equity buy-outs, and out-of-court supervision arrangements. For example, in another rehabilitation case in which an insurer successfully emerged, the Virginia Corporation Commission approved a rehabilitation plan that terminated the proceedings upon the closing of a stock purchase agreement. *State Corp. Comm'n v. Shenandoah Life Ins. Co.*, No. INS-2011-00155, Final Order Approving Plan (Va. State Corp. Comm'n, filed Oct. 20, 2011). The exchange involved a sale of capital stock of the company in rehabilitation which enabled the company to perform under the terms of the plan. *Id.* ¶ 6. The terms of the stock purchase agreement required, among other things, the sale of stock to a purchaser in exchange for the purchaser's recapitalization of the company to surplus levels that were acceptable to the rehabilitator. *State Corp. Comm'n v. Shenandoah Life Ins. Co.*, No. INS-2011-00155, Application for Final Order Approving Plan (Va. State Corp. Comm'n, filed June 23, 2011). Absent a recapitalization, the company would likely not have emerged from rehabilitation or, alternatively, would have remained stuck in the proceeding as part of a long-term runoff with future risk. *Id.* ¶ 52. According to the deputy receiver, without an approval of the plan and corresponding exchange, distributions to policyholders would have been

limited as there was substantial doubt whether sufficient funds would remain to pay policyholders as part of a runoff, or liquidation. *Id*.

The Second Amended Plan provides all stakeholders the best opportunity for a favorable outcome to these proceedings. Specifically, the Consensual Transaction pays remaining policy claims in full at closing and ends Court and Rehabilitator oversight. On the other hand, the Rehabilitator here projects a substantial risk of nonpayment if the Plan simply remains in place as part of a long-term runoff, similar to the potential negative consequences facing the policyholders in *Shenandoah*. In fact, the Interim Payment Percentage has not been increased since July 2014. The Rehabilitator believes that continuing down the path of the current Plan does little to benefit policyholders given the continued risks and substantial timeline for completion.

The Second Amended Plan addresses this long-term runoff and eliminates the need for further administrative and Court oversight. This will substantially reduce the costs needed to carry out the provisions of the Second Amended Plan, unlike the current structure. Left alone, the Plan would necessarily continue litigation and this Court's oversight indefinitely. The Second Amended Plan, after implementation, will allow for discharge of the SDC and an end to the Court proceedings. This is a substantial benefit to parties involved as operating expenses and Court time and resources spent on this Rehabilitation proceeding will all be eliminated.

C. The Consensual Transaction Is the Result of a Reasonable and Fair Process

Although the Rehabilitator's business judgment is entitled to deference, as a policy matter, the Rehabilitator and OCI want to reassure the Court, Interested Parties, and the public generally that reasonable steps were taken to help ensure that the statutory objectives of rehabilitation are met here. The following demonstrates that the process undertaken to effectuate an exit from Rehabilitation was reasonable and fair.

From the start, the Rehabilitator has maintained the www.Ambacpolicyholder.com web site and regularly communicated the status of the Rehabilitation Proceedings with the public in general and Interested Parties in particular. Events in the process to date have been reported timely. The web site reflects that the Rehabilitator has established a reasonable process to keep Interested Parties updated on negotiations, the terms of the Consensual Transaction, provide answers to anticipated Frequently Asked Questions, and field specific questions from Interested Parties about the Transaction. Any interested party with a concern has thus been provided with a forum and a mechanism to be heard.[44]

More recently, the Rehabilitator held listening sessions on July 12, 2016 to address the status and future of the Rehabilitation and on August 24, 2017 to answer questions in particular about the Consensual Transaction.[45] In each instance, the SDC solicited and addressed specific questions from Interested Parties. The August 24, 2017 listening session was attended by over 30 individuals, representing various stakeholders in the Rehabilitation, including General Account policyholders, GA Surplus Note holders, AAC-insured securities, DPO Holders, and equity investors of Ambac Financial Group, Inc., among others.[46]

Last, AAC and the Rehabilitator are filing with the Court a Disclosure Statement that is also being disseminated to Interested Parties via the website. Although not required by law, the Disclosure Statement provides transparency by detailing the steps taken to reach agreement for the Consensual Transaction, analyzes the Transaction and explains the Rehabilitator's

[44] Throughout the process, the Rehabilitator has also specifically engaged three of the remaining original policyholders, namely the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corp. ("Freddie Mac") and the National Credit Union Association ("NCUA") to hear their concerns and seek their consent to the Transaction. Those discussions were ongoing as of the filing date of this Motion.

[45] Schwartzer Aff. at ¶ 17.

[46] *Id.* at ¶ 18.

conclusions, and the bases therefore, that the resulting financial structure of AAC is durable. The Rehabilitator's intent in filing and disseminating the Disclosure Statement is to provide an additional layer of public disclosure to policyholders that were not part of the Ad Hoc Group. The Court of Appeals in this case held previously that admission of such a Disclosure Statement was permissible as it did not adversely affect a substantial right of any party. *Nickel*, 351 Wis. 2d 539, ¶ 122.

The Consensual Transaction is the product of the negotiations between sophisticated parties that have sought out and retained expert advisors in the field of insurance rehabilitation. Once negotiations between AAC, AFG, and the Ad Hoc Group began in earnest last December, the Rehabilitator announced publically that OCI preferred a resolution to the Rehabilitation based on at least majority consent by constituents, rather than a Court-ordered exit. Although the Rehabilitator did not participate in the negotiations, it did monitor the progress of negotiations with its advisors and guide the parties to a resolution that would pass the Rehabilitator's durability test.[47] No exit plan would be sensible if it resulted in AAC or the Segregated Account slipping back into Rehabilitation.

To meet this durability test, it is the Rehabilitator's belief that both AAC and AFG made significant concessions to reach the Consensual Transaction including: AFG accepting a less attractive consideration package than is available to non-affiliated third party DPO beneficiaries and Surplus Note holders and agreeing to the issuance of the new Tier 2 Notes and Senior Secured Notes, that are instruments with higher interest rates than current DPOs. These concessions increased the value of consideration distributed to non-affiliated third parties, enhanced AAC's durability, and better aligned the interests of AFG with that of AAC

[47] Schwartzer Aff. at ¶ 12.

stakeholders. Such concessions by AAC would also not have been possible without the 6.5% discount imposed on all claims; although as described previously, the discount has been mitigated to affect only accretion, not principal payments on claims. The resulting Transaction treats all interested parties fairly and is therefore, on balance, in the best interest of policyholders, creditors and the public.

D. Post-confirmation, OCI Retains Regulatory Authority over AAC

OCI's principal method to protect policyholders is to ensure durability of any exit transaction. In addition to weighing the proposed Transaction on the most significant stress case scenario and building in a material margin of safety above and beyond any claims-paying resources, OCI also will retain its statutory authority to regulate AAC after the Rehabilitation is closed. To be sure, AAC will receive enhanced regulatory scrutiny for a period of time to be determined by the Commissioner, which is a natural consequence of the Rehabilitation on AAC's post-emergence period of operations.

As reflected in the Wisconsin Statutes, OCI has many potential measures at its disposal to help ensure AAC's claims-paying ability on a going-forward basis. Generally, Wis. Stat. § 601.41 requires that OCI administer and enforce all insurance statutes in Wisconsin (chs. 600 to 655). Such requirements include but are not limited to OCI's monitoring of AAC, targeted examinations of AAC under § 601.62, issuing rules and remedial orders under § 601.41, requiring reporting by AAC to ensure compliance with Wisconsin law, and continuing to oversee AAC's solvency and financial conditions to foster the protection of policyholders.

As reflected in the Wisconsin Administrative Code, insurers are required to file audited annual financial statements and subject themselves to examination by OCI at any time. *See* Wis. Admin. Code Ins §§ 50.20, 50.50. Further, the Administrative Code also establishes "the amount of capital and compulsory surplus an insurer is required to maintain to provide reasonable

security against contingencies affecting its financial position. . . ." Wis. Admin. Code Ins § 51.80(1). This oversight of AAC's operations will continue after conclusion of the Rehabilitation of the Segregated Account.

These important regulatory measures will be implemented, after Court approval of the Second Amended Plan, by stipulation. That is, as a condition to exit, OCI insists that AAC abide by enhanced regulatory requirements and agree to such requirements in writing, to be then included in a stipulated order of the Commissioner. OCI has proposed and AAC has agreed to various items, including but not limited to, a prohibition on financial transfers to affiliates without OCI approval, expanded and more frequent (*i.e.* monthly) financial reporting to OCI, advanced approval of any changes to AAC's business plan, notice of any delays or major developments in the RMBS Litigations, and consent by AFG as well to make financial reporting. The availability of these regulatory measures and AAC's and AFG's agreement to subject themselves to enhanced regulatory oversight reinforces the Rehabilitator's conclusion that an exit from Rehabilitation now will stand the test of time.

CONCLUSION

For the foregoing reasons, the Rehabilitator respectfully requests that the Court enter the Scheduling Order, schedule this case for further proceedings, and grant its Motion to approve the Second Amended Plan to effectuate an exit from Rehabilitation by the Segregated Account.

Dated at Milwaukee, Wisconsin this 25th day of September, 2017.

MICHAEL BEST & FRIEDRICH LLP

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